FINANCIAL FRAMEWORK FOR NORTHERN IRELAND WATER LIMITED

INTRODUCTION

In April 2007, Water Service is to become a Company wholly-owned by Government to be known as Northern Ireland Water Limited (NIW). At the same time the Northern Ireland Authority for Utility Regulation (NIAUR) will assume responsibility for the economic regulation of the Company, while the Environment and Heritage Service (EHS) and the Drinking Water Inspectorate (DWI) within DOE will be responsible for environmental and water quality regulation. The Consumer Council for Northern Ireland (CCNI) will represent the interests of consumers on water and sewerage issues.

The Government has been working to establish a financial framework for NIW and this has now been settled for the period from 2007/08 to 2009/10. In particular, this sets out the amount of revenue that NIW will be allowed to recover from customers over this period. This paper outlines the key elements of this framework.

STRATEGIC AND FINANCIAL REVIEW

In August 2004, John Spellar MP announced the intention to conduct a Strategic and Financial Review (SFR) of Water Service to provide advice on a range of strategic options for financing and managing the new company. A Consortium led by UBS Investment Bank was appointed to undertake this exercise and a Report setting out their findings was published in February 2006 and is available at http://www.waterreformni.gov.uk. It made a number of recommendations which the Government considered carefully before publication.

Structure

The Consortium who conducted the Review considered structural and financial options for the future delivery of water and sewerage services

ranging from continued public sector delivery, to full privatisation of water and sewerage services.

The Government noted carefully the report's conclusions that the greatest efficiency improvements in the service, and thereby lower bills for customers, are likely to be realised where there is private sector participation and where the company enjoys independence from Government. It concluded however that it would not be practicable, nor sufficiently acceptable, in the short-term to introduce private sector equity participation. Furthermore, the Government's consultation on Water Reform in 2003 indicated a lack of public support for the privatisation of Water Service.

Consequently the Government decided that water and sewerage services would be delivered under a government corporation model under which Water Service would be wholly government-owned, but subject to Companies Order legislation once the new company is established in April 2007. It is currently planned to conduct a review in 2008 to determine whether increased private sector participation would be beneficial.

Recommended Regulatory Framework

The Government accepted the Consortium's recommendation that the regulatory framework for NIW should be based on the model currently operating in England and Wales.

This framework is being adopted as a means of incentivising NIW to:

- achieve continued challenging efficiencies and lower tariffs;
- implement and deliver an efficient and effective customer service system which reflects best practice; and
- meet domestic and European water quality and environmental standards.

The regulatory regime will include risk mitigation mechanisms such as interim pricing determinations to deal with unforeseeable circumstances and will come into effect from April 2007. Similarly the Regulator will approve the charging schemes for 2008/09 onwards under a new licence authorising NIW to provide water and sewerage services.

In the absence of a competitive water industry in Northern Ireland, the Water and Sewerage Services (Northern Ireland) Order 2006 enables a comprehensive regulatory structure to be put in place to ensure the proper running of water and sewerage services.

Principally, the role of water regulation will fall on the Northern Ireland Authority for Utility Regulation (NIAUR), which will discharge its functions independently of Government, but will work closely with:

- The Department for Regional Development (DRD) in its policy role for the water and sewerage industry;

- The Consumer Council for Northern Ireland (CCNI), which as an independent organisation will represent consumer interests;

- The Drinking Water Inspectorate (DWI), which will set standards and monitor compliance of the quality of drinking water; and

- The Environment and Heritage Service (EHS), which regulates and enforces water abstraction consents and quality standards in inland, estuarial and coastal waters.

The day to day running of the Northern Ireland's water and sewerage services is a matter for the operational teams in NIW. However, NIAUR will facilitate a well managed and efficient water industry by:

- ensuring companies are able to carry out their responsibilities under the Water and Sewerage Service (Northern Ireland) Order 2006;

- setting limits on what companies can charge its customers from 2010 onwards; and

- securing appropriate quality standards and customer service standards.

The regulatory framework set out for NIAUR, DWI and EHS in the new legislation will deliver value for money for customers by:

(i) ensuring NIW meets its conditions as specified under the Licence;
(ii) monitoring customer service standards provided by the company;
(iii) ensuring that NIW supplies a safe supply of drinking water, and that its sewage discharges are adequately treated; and
(iv) if necessary, imposing penalties on the company if it contravenes its conditions of appointment.

In particular, and to ensure value for money, NIAUR is expected to engage in a range of activities:

- **Comparative Regulation:**
  The OfWat model of regulation (which is the model for local regulation) involves the comparison of the operating and capital costs of companies in the industry in England and Wales to assess their relative efficiency. This assessment is made through statistical analysis, and a comparison of the companies cost bases and unit costs. The Regulator then sets efficiency targets for each company on the basis of the efficiency gap that it needs to close. The Regulator also makes an assumption of current and future industry productivity and efficiency as a whole, in setting these targets.

- **Incentive Regulation:**

  In England and Wales changes in the average price that a company can charge over a five year period are determined in the Regulator's Periodic Review. Price limits are set by the formula RPI+/- K; where RPI is the rate of inflation or Retail Price Index in the November prior to the start of the charging year, while K is an adjustment factor, which is set individually for each water company by Ofwat.

  Included in K, are assumptions about the company's efficiency gains which are expected to be made on the basis of the results of the Regulator's comparative efficiency analysis. The Regulator targets the company to close the gap in terms of efficiency by a certain percentage within the five year regulatory cycle. Any failure to achieve this assumed percentage will have to be absorbed as a loss for the company. Other items which can be included in K are expenditure for environmental improvements, enhanced service levels, improved drinking water quality and financeability.

  While the Regulator will set demanding and challenging targets in terms of prices, it is important that there is also scope for the company to outperform the assumptions. This is the basis of incentive regulation. If out-performance occurs, the company can keep the surplus revenue - as an incentive to outperform the Regulator's prices. In England and Wales, companies are allowed to retain the benefits of out-performance for five years, after this, benefits are passed back to customers in the form of lower bills.

- **Customer service regulation**

  In addition to the above safeguards on quality and customer service, it is planned to establish a Guaranteed Standard of Service scheme (GSS). In England and Wales the GSS Scheme is a set of minimum standards, where if breached by the company, customers are entitled to a compensation payment. The standards include targets on matters such as

making and keeping appointments, responding to account inquiries and dealing with interruptions to supply.

Corporate Governance

NIW's Board will be appointed in accordance with the Combined Code of Corporate Governance. The legal and corporate governance structure will be established with the objective of:

(i) maximising the likelihood that efficiency gains can be realised;

(ii) ensuring there is accountability to environmental and water quality Regulators as well as to customers for the quality of the service provided;

(iii) ensuring there is clarity about the nature of the relationship between the Government and the company so as to reduce political and regulatory risk.

Remuneration policies will be agreed by DRD as the shareholder with a Remuneration Committee established by NIW in accordance with the Combined Code of Corporate Governance. Remuneration policy will be designed to incentivise performance and will take account of appropriate market-based compensation levels. The arrangements will provide an important means of facilitating the recruitment and retention of high calibre management and motivating them to achieve and out-perform company and shareholder objectives.

As a general principle, packages will clearly reward success while not providing awards for failure to perform.

OPERATING COSTS

The financial framework covers a seven year period setting out the high level costs that the company is expected to incur and the revenue that it will be allowed to recover. While the Department will set the revenue requirement and charges that will apply for the first three years, the Regulator will review costs as part of the Price Review in 2009 to set prices for 2010/11 to 2014/15. The following paragraphs outline the operating costs the company is expected to incur over the three year period to 2009/10.

The projected nominal operating costs of NIW for the three years are detailed in Table 1:

Table 1: Operating Expenditure 2007/08 - 2009/10

	2007/08 £m	2008/09 £m	2009/10 £m
Operating costs*	190	197	188

* Nominal operating costs exclude PPP costs

These costs reflect the day to day running costs of the company including the extra costs (eg power and chemicals) arising from recent and new investments. They also include the costs to transform the business, for example through new systems to support Regulation and projects that will result in improved efficiency.

Water Service has been increasing its efficiency as part of the Water Reform programme since 2003/04. By 2006/07 Water Service annual efficiency gains were £24.6m. By 2009/10 this is projected to nearly double at £47.4m p.a.. This represents a challenging efficiency target for the company (yet one that is capable of being out-performed) in the context of a demanding programme of business transformation and the magnitude of the capital works programme

to be delivered to achieve rapidly improving standards of environmental compliance and network servicability.

The Strategic and Financial Review identified three efficiency scenarios – 20%, 30% and 40%. This financial framework approximates to slightly above the 20% scenario. Following detailed analysis of the existing state of the company's management and information systems and network assets, and the organisation's capacity for change are such that it has been concluded that the higher levels of efficiency modelled in the Strategic and Financial Review are not realistic by 2009/10.

Setting the efficiency targets at this level strikes the difficult balance between pressing the new Board and management team to realise a challenging efficiency target whilst implementing a level of business transformation unparalleled in England and Wales's historic Regulatory regime. The scale of transformation was one of the factors that extended the business planning horizon to 7 years within the approved Strategic Business Plan. This provides a sufficient period for the scale and nature of investment in the network and business transformation to be made and to generate benefits in terms of both quality of service and operating efficiencies. In the period to 2013/14, the company is projected to make annual efficiency gains of £66.1m.

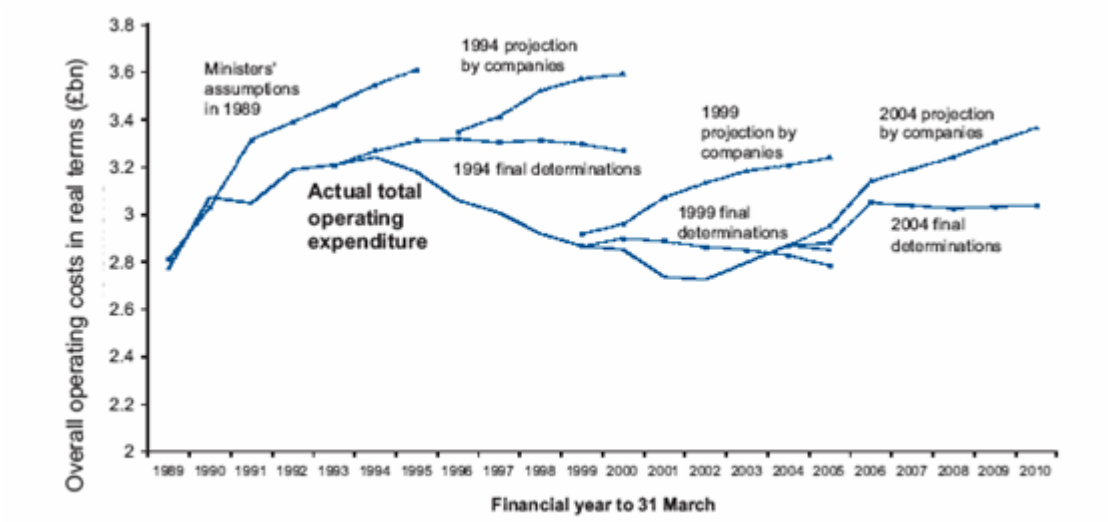
In addition to the operating expenditure above, the company will also incur PPP costs of £20m in 2008/09 and £38m in 2009/10. These PPP costs are the annual charges associated with the new works procured under the PPP programmes upgrading 50% of Northern Ireland's water supply capacity, 20% of the waste-water treatment capacity and 100% of the sludge disposal capacity.

PPP contract costs will be treated as any other cost in the first and subsequent Price Reviews. They will be subject to the same scrutiny for efficiency by the economic Regulator as any other cost. Prior to the first price review during the phasing-in period of tariffs, if there are any material changes in projected PPP contract costs, such changes will be scrutinised by the

Regulator and if found unacceptably inefficient, will be borne by the company and not adjusted in tariffs.

As indicated above, NIW is being set up in the context of incentive regulation. Therefore it will be set up with the appropriate freedoms, flexibilities and incentives to provide for out-performance of these costs. Figure 1 indicates that in England and Wales water and sewerage companies have tended to outperform both their initial projections and final price determinations. Again, the Regulator in Northern Ireland will also be examining the level of efficiency in the company as part its Price Review for the 2009 Price Determination.

Figure 1: Performance Against Operating Cost Targets in England and Wales Since Privatisation (2003-04 prices)



Source: Water Industry Commission for Scotland – Strategic Review of Charges 2006-10: Final Determination

CAPITAL EXPENDITURE

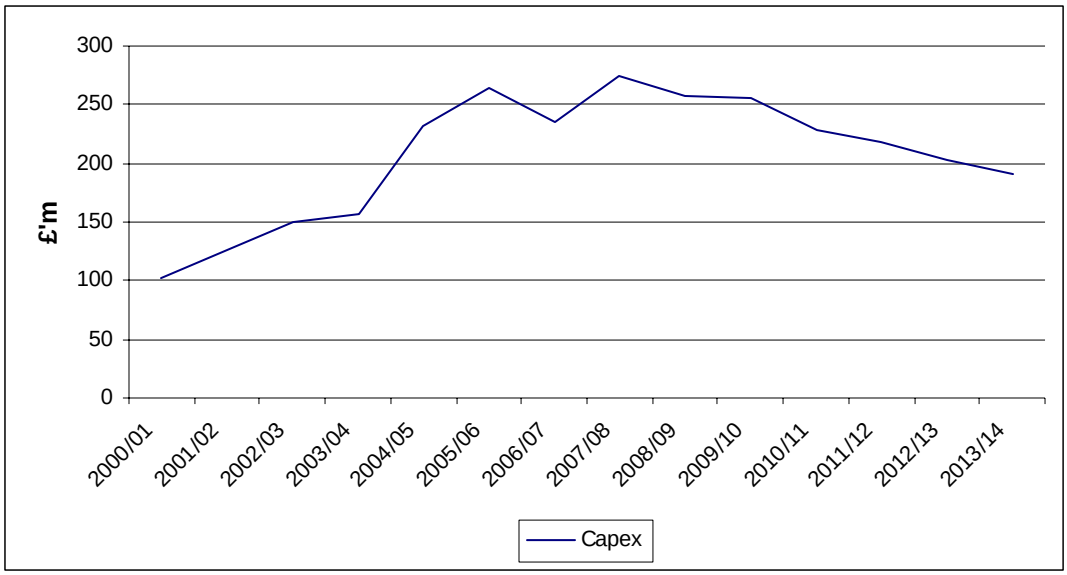
Table 2 details the level of capital expenditure over the next 3 years.

Table 2: Capital Expenditure 2007/08 – 2009/10

	2007/08 £m	2008/09 £m	2009/10 £m
Capex	273	256	253

The capital programme continues the recent trend of substantial levels of investment in the infrastructure which will see a total of £1.5bn invested in water and sewerage infrastructure over the period 2004/05 to 2009/10 before charges will be fully phased in. Figure 2 profiles planned expenditure over the full seven years of the financial framework..

Figure 2: Capital Expenditure between 2000/01 and 2013/14



The majority of the 2007/08 to 2009/10 capital programme is directed towards the sewerage assets reflecting the necessary priority given to meeting required standards and realising environmental improvements (in fact around

75% of the capital programme is devoted to sewerage assets in the first 3 years). The levels of capital investment allowed for within the financial framework are higher than had been previously estimated reflecting a more detailed assessment and audit of the costs of delivering the necessary improvements in infrastructure to meet performance criteria confirmed as appropriate by the Environmental and Water Quality Regulators.

The planned programme for the period 2010 – 2014 assumes that major investment will be required in the water and wastewater networks to improve infrastructure, to reduce pollution incidents and to increase the security of supply to customers. However, the actual capital programme will be confirmed as part of the 2009 Periodic Review of prices by NIAUR and the associated NIAMP3 prepared by management, reviewed by the Reporter and agreed by the Environmental and Water Quality Regulators.

The average annual capex per property at 2007/08 prices is around £375. This level of investment is higher than the industry average in England and Wales as shown in Table 3. The average annual capital expenditure per property of some selected comparator companies are provided below.

Table 3: Average Annual Capital Expenditure (2007/08 prices)

	Dwr Cyrmu	South West	Wessex	E&W average	NIW
£ per property per year	199	243	215	165	376

The capital expenditure itself it not recovered through revenue. Rather the associated depreciation and infrastructure renewals charge is recovered. The total depreciation and infrastructure renewals charges projected for NIW (including that on the opening value of the assets) are as detailed in Table 4.

Table 4: Depreciation and Infrastructure Renewals Charge

	2007/08 £m	2008/09 £m	2009/10 £m
Depreciation and Infrastructure Renewals Charge	48	57	66

The capital works programme will provide customers in Northern Ireland with improved services. Water quality will improve markedly and by 2010, the percentage of properties experiencing supply interruptions exceeding 12 hours should halve from 2006/07 levels. On the waste water side, major projects such as the Belfast Sewers project will be completed and over 100km of sewers will be renovated and replaced. The percentage of the population equivalent served by compliant wastewater treatment works will increase markedly from 77% to 94%. Leakage rates, which have reduced over the past 5 years by 42%, are expected to decrease by a further 20% from 2007/08 to 2009/10.

The tariffs charged over the next three years need to be seen in the context of the operating and capital costs of Northern Ireland Water. Table 5 below shows the average domestic tariff that the company would have to charge to fully recover all of its costs, referred to as the 'full cost tariff'.

Table 5: Full Cost Tariff

	2007/08 £	2008/08 £	2009/10 £
NIW	302	350	379

In the first three years domestic tariffs will be phased in and "pegged" to England and Wales overall average levels. This phasing in of tariffs and pegging to the England & Wales average will save the average household about £380 in charges over these three years when compared with the full cost tariff, that is, the underlying tariff the company would charge in the absence of these subsidies.

DRD has approved the first charging scheme prior to 1 April 2007 as part of the transitional arrangements. The first charging scheme brings together the full details of the comprehensive water and sewerage charges that the new company will apply in 2007/08.

For the first three years, Shaun Woodward (who was then the Minister for Regional Development) announced on 8 December 2005 the Government's intention to set the new household charges in line with the average level of charges that will apply in England and Wales in the three year period to 2009/10. Thus, the Government is setting the new domestic charges in line with the average level of charges that will apply in England & Wales in the three years to 2009/10, and these will be phased in over that period.

All households and non-domestic customers have been advised of the level of charges they may be expected to pay in these three years. A detailed charging scheme for 2007/08 has also been published which sets out in detail the charges that will apply in the first year. Going forward the Regulator will approve the detailed charging schemes for both 2008/09 and 2009/10. The charges will be phased in over three years (on a one third, two thirds, full charge basis). Table 6 sets out the average charges that domestic water and sewerage customers can expect to pay.

Table 6: Average Domestic Charges 2007/08 –2009/10

Average tariff	2007/08 £	2008/09 £	2009/10 £
Combined water and sewerage – Phased	100	214	334

To further ease the transition, a Reduced Tariff will be introduced. This tariff is specifically designed so no-one on low income will spend more than 3% of their income on water charges. Those eligible for the Reduced Tariff include those households in receipt of Housing Benefit, Rate Rebate and the new Low Income Rate Relief, as well as all householders under 18, who are in full

time education or training and children leaving care up to the age of 21. The scheme will be phased in over the next three years, and is likely to benefit up to 200,000 households. It is expected to cost around £35m in 2009/10 when charges are fully phased in and is to be funded by Northern Ireland public expenditure subsidy, not other customers. While this reduced tariff is due to be reviewed after three years, the long-term modelling assumes that it will continue beyond 2009/10 – however, the precise nature of the protection scheme will be a matter for ministers to determine at that time.

Government policy is to implement a long term managed transition to widespread metering. Meters will be installed on all new connections to the water and sewerage networks made after 1st April 2007 and all customers aged 60 or older will be able to opt for a metered tariff. Information on taking up this option has already been sent to the many householders who have requested it.

The Minister also confirmed that the domestic metering policy would be reviewed within two years (i.e. before charges are fully phased in 2009/10) with a view to extending the domestic metering option to further groups from 2009/10 thus making metering more generally available to customers.

Comparisons

The costs associated with the delivery of water and sewerage services in a region are influenced by many local factors, a fact reflected in the diverse range of water and sewerage charges levied in England and Wales. Typically, these factors relate to the geography of the region, particularly topography and population / customer base. For example, a region like Northern Ireland with a low population density will require a greater length of water main per household served requiring greater capital maintenance and operating expenditure per customer. Also, a smaller customer base will impact on the magnitude of fixed costs per customer. Furthermore, many companies face atypical costs which are not faced by other companies which would intuitively be considered comparable.

Table 7 illustrates the average tariff charged by companies in Great Britain which have similar operating environments to Northern Ireland Water given their topology and population. It shows that NIW's full cost tariff exceeds the England and Wales average but falls within the range of companies with similar operating environments (Scottish Water, Dwr Cymru, South West, and Wessex).

Table 7: Average Domestic Tariff Comparison

	2007-08 £	2008-09 £	2009-10 £
England and Wales average	**307**	**321**	**334**
Scottish Water	302	309	317
Dwr Cymru	365	383	398
South West	478	491	502
Wessex	354	375	393
NIW (full cost tariff without phasing and pegging subsidies)	**302**	**350**	**379**

In terms of the non-domestic sector, any new/additional charges to customers will also be phased in over the next three years. Water usage and sewage discharge varies greatly in this sector and consequently average tariffs are least meaningful. Detailed illustrations of the non-domestic charges coming into effect in April 2007 and how they will impact on different types of businesses can be found at http://www.waterchargesni.gov.uk/index/non-domestic_content.htm.

Forward look

During 2009 the Regulator will complete a full Periodic Review and will make a Price Determination which will then set the level of tariffs that can be charged for 2010/11 – 2014/15. The company will be incentivised to outperform against the costs set out in its Strategic Business Plan and the Government expects that NIW will be able to outperform its targets in the same way that companies in Great Britain have done (see Figure 1).

The Regulator in Northern Ireland will take any out-performance into account when setting tariffs from 2010/11 onwards to ensure that all realised and projected efficiencies have been reflected appropriately in tariffs to ensure that they are as low as possible.

It is not possible at this time to accurately forecast what the level of future tariffs the Regulator will determine in its Price Control review. However, the financial model underpinning the agreed financial framework does provide an estimate of the level of tariff that would need to be charged to recover the projected costs of the company going forward. This is based on a current set of assumptions of future operating costs and capital investment for those years, and an assumption that the Strategic Business Plan will be delivered on time and as a result will realise the expected improvements in business performance (both efficiency and quality of service). The resulting tariff estimates are set out in Table 8.

Table 8: Forecast tariffs to 2013/14

Average water & sewerage charge	**2009/10 £**	**2010/11 £**	**2011/12 £**	**2012/13 £**	**2013/14 £**
Estimated domestic	379	397	420	444	469

Note: The 2009/10 tariff is the full cost reflective tariff in 2009/10. The subsidised tariff in 2009/10 will be £334. Tariffs are quoted in nominal prices.

These estimates are based on current assumptions about the nature of the business and its performance. They should not be seen in any sense as planned or actual tariffs. These are for the Regulator to determine in light of the information gained during the 2009 Price Review. This information will provide greater clarity and confidence around the efficient level of costs (including expectations of out-performance) in the updated Strategic Business Plan and the appropriate level of capital investment required to meet environmental and service standards prescribed at the time.

OFWAT have not yet announced tariffs beyond 2009/10. However, OFWAT have published a report, “Water Industry Forward Look 2010-30”, which sets

out a range of tariff scenarios beyond 2009/10. Table 9 below illustrates the average England & Wales domestic tariff under both a high and low cost scenario and then compares this against actual NIW tariffs and NIW cost reflective tariffs.

Table 9: Projected Domestic Combined Tariffs

Nominal Prices	2007/08 £	2009/10 £	2010/11 £	2011/12 £	2012/13 £	2013/14 £
A) E&W – High Cost Scenario[1]	307	334	369	409	452	500
B) E&W – Low Cost Scenario[1]	307	334	362	393	426	463
C) NIW Customer Tariffs	100	334	397	420	444	469
D) NIW Cost Reflective Tariffs	302	379	397	420	444	469

Sources: most recent periodic reviews, "Water Industry Forward Look 2010-30" Ofwat
[1] High and Low cost scenario's are based on the OFWAT forecast report
Tariffs are quoted in nominal prices.

CAPITAL STRUCTURE

The Government's objective for NIW is to establish a company which has a stable and sustainable capital structure so that taxpayers are not subject to unacceptable financial risk, and so that the company is able to plan for the future with confidence. It is also the Government's intention that the new company should deliver sustained positive returns to the taxpayer (as shareholder). The cost of capital represents the opportunity cost that the Government faces when investing taxpayers' funds in one particular business activity rather than another.

The SFR recommended that the opening asset value or Regulatory Capital Value (RCV) of Northern Ireland Water should be set in the region of £1 billion. This recommendation was based on the Consortium's analysis of the opening RCV required to achieve a self-financing structure for the company based on the available information at the time. The Consortium explored a range of scenarios of opening RCV ranging from £300 million to £1.3 billion. It was their view that the opening RCV needed to be in the region of £1 billion to meet the requirement for the Company to be a stand-alone and fully

financeable business given the operational challenges it faces and the substantial investment required.

This was tested by applying three valuation methodologies typically used by equity investors in regulated infrastructure companies throughout Europe, namely: a discounted cash flow approach, a comparison with other quoted companies; and an analysis of historical public transactions in the UK water sector.

The RCV is a proxy for the current value of NIW's assets on which it is allowed to earn a return to compensate investors of capital (i.e. the taxpayer). The opening levels of the RCV and equity need to be set at levels which are high enough to satisfy the Regulator that the company is sufficiently financially robust to sustain future investment requirements. The RCV also needs to be low enough to deliver affordable tariffs.

The SFR recommended a cost of capital of 6.3%, as compared to the England & Wales comparator of 5.8%. The Consortium felt that the risk profile of NIW warranted an additional risk premium. It was also decided that the capital charge in the DRD Departmental Expenditure Limit (DEL) budget would be set at the same level as the return that NIW should earn. This would therefore require DRD to extract NIW's return to cover its cost of capital charge. This is consistent with the Treasury's guidelines on setting required rates of return for state-owned companies.

Since that time further work has been undertaken. Government has set the cost of capital (WACC) at 6.4% (real). This is at the upper end of Ofwat's range for established businesses in England and Wales (allowing for NIW's projected mix of debt and equity or "gearing"), and is consistent with the SFR Consortium's assessment of the higher risk profile of NIW compared to other more established operators.

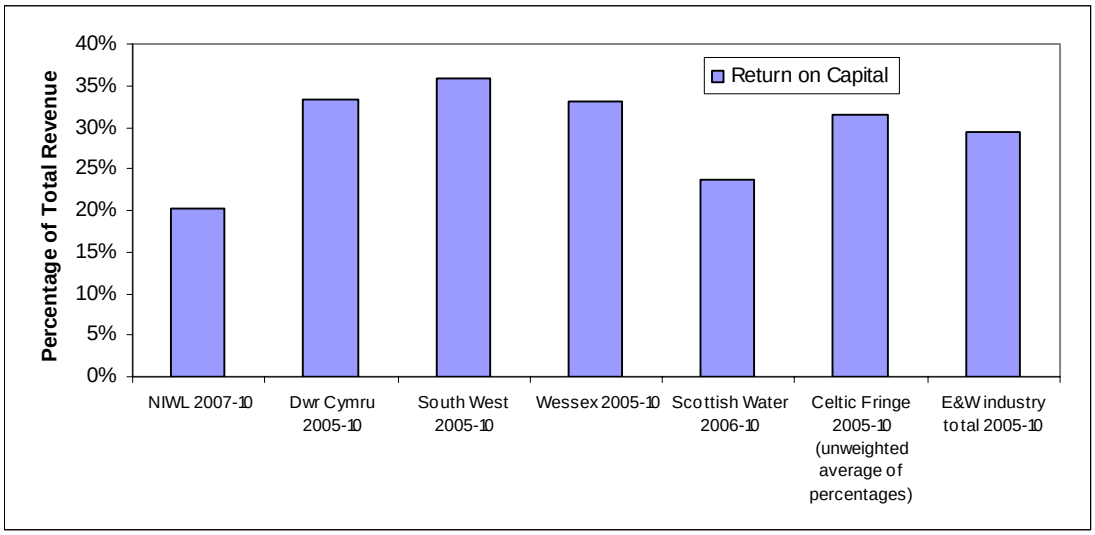
When the SFR was published, Government had decided that the opening asset value of NIW (the Regulatory Capital value or RCV) should be £1 billion

and that all of this should be reflected in the opening balance sheet of the company as equity.

The RCV and initial capital structure have been set following an extensive review of projected quality compliance requirements of NI Water, investment needs to fund network enhancements and business transformation, and creation of a sustainable business over the long term. These requirements have been balanced with the need to charge fair and affordable tariffs in line with tariffs charged in England and Wales. As a result of this review the Government has decided to reduce the RCV to £800 million with £150 million of this being reflected as opening debt on the Balance Sheet. This represents some £5.2 billion write down of the value of the assets in Water Service's accounts.

The projected combined return on capital as a percentage of total revenues in the first three years is on average 20%. This is lower than comparable companies as Figure 3 indicates.

Figure 3: Financing Costs



Note: 'Celtic Fringe' is used to refer to a number of companies having similar characteristics to that of NIW e.g. rurality, topology. Companies include: Scottish Water; South West Water; Welsh Water; and Wessex Water.

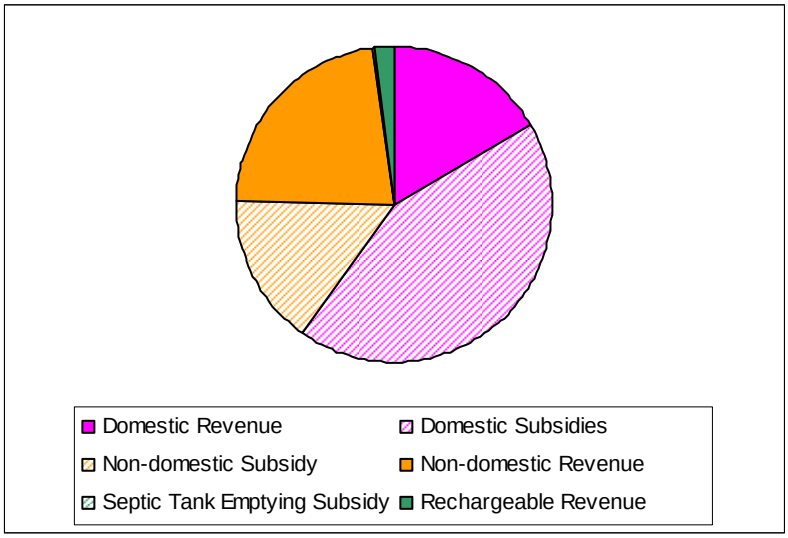
The RCV will change over time to reflect the ageing of existing assets and investment in new assets. The cost of ageing assets will be recovered

through infrastructure renewal and depreciation charges (see above). The RCV is multiplied by the allowed rate of return to establish the cash return allowed on the RCV. This should ensure that customers only contribute towards those assets that have been created and which continue to provide a benefit to customers.

SUBSIDY AND PUBLIC EXPENDITURE

NIW's revenue during its first three years will be a mix of direct charges to different customer groups and DRD subsidies. Figure 4 illustrates the proportions of each of these sources of NIW's total income, with 59% of NIW's revenue being derived from subsidies in 2007/08.

Figure 4: Source of NIW Income 2007/08



There are a number of subsidies to NIW during its first three years reflecting Government policy to phase-in tariffs and ensure that charges are fair and affordable. These are:

- **Phasing subsidy:** This subsidy reflects the government's commitment to introduce the new water and sewerage charges from 1 April 2007 on a phased basis. Customers will pay one third of the charge in 2007/08 rising to two-thirds of the charge in 2008/09 with full charges by 2009/10.

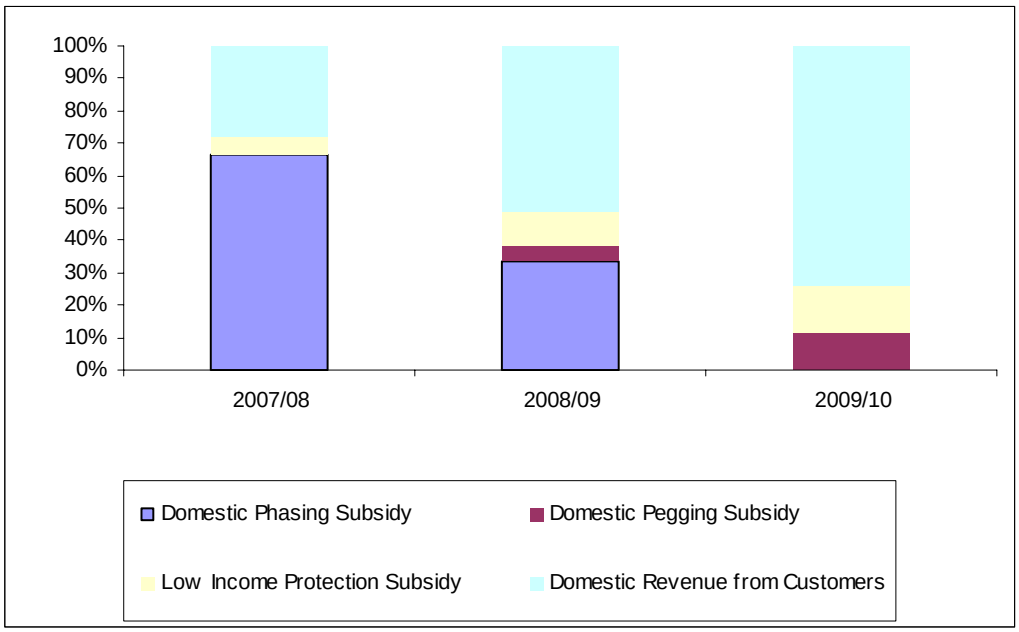
The new charges for emptying septic tanks will be similarly phased in. Regarding connection charges, the new infrastructure charges for water and sewerage and the reduction of the reasonable cost allowances will also be phased in.

- **Pegging subsidy:** The government has also committed that average household bills for the phasing-in period from 2007/08 to 2009/10 would be in line with England and Wales average household bills. This subsidy allows the domestic tariff to be "pegged" to this level.

- **Low income protection subsidy:** To help ease costs for low income households, Government has announced that it will be provide a low-income protection scheme in the form a Reduced Tariff (see above). The Reduced Tariff is designed to guarantee that no-one on low income need spend more than 3% of their income on water and sewerage charges. The low income protection subsidy is to provide for the Reduced Tariff. Although the scheme is to be reviewed after three years, the long term modelling for NIW assumes it continues in its current form but as indicated above the precise nature of the protection scheme will be a matter for ministers to determine at that time.

Figure 5 shows the tariff income from domestic customers and the associated subsidies.

Figure 5: Breakdown of Total Domestic Revenue



Although the Reduced Tariff is projected to continue, Water Reform and the removal of water and sewerage services from central government will release public funds which may be used to meet the needs of other key public services such as education and health. This will help Northern Ireland to keep pace with improvements in these services in GB that would not otherwise be possible while Northern Ireland's water and sewerage services are financed from public expenditure. The latest analysis of Water Service costs projects that £300m of resources will be released for other public service by 2013.

Annex- 1:*P&L*

	2005/06 £'000 AUDITED ACCOUNTS	2006/07 £'000 CURRENT FORECAST	2007/08 £'000 WS BUSINESS PLAN MODEL	2008/09 £'000 WS BUSINESS PLAN MODEL	2009/10 £'000 WS BUSINESS PLAN MODEL	2010/11 £'000 WS BUSINESS PLAN MODEL	2011/12 £'000 WS BUSINESS PLAN MODEL	2012/13 £'000 WS BUSINESS PLAN MODEL	2013/14 £'000 WS BUSINESS PLAN MODEL
Revenue									
Income from customers	37,157	37,274	121,041	217,371	319,823	355,877	376,715	399,439	424,841
Government Subsidy [1]	-	-	182,767	134,542	62,122	44,952	48,517	50,963	54,204
Rechargeables	4,141	4,596	3,582	4,241	3,460	3,547	3,635	3,726	3,819
	41,298	41,870	307,391	356,153	385,406	404,376	428,867	454,128	482,864
Expenditure									
Operating Expenditure	(150,348)	(159,416)	(190,120)	(197,473)	(187,738)	(181,386)	(189,459)	(192,039)	(195,902)
PPP/PFI Operating Expenditure	(2,243)	(2,284)	(1,912)	(20,371)	(37,659)	(38,296)	(38,937)	(39,507)	(39,538)
Depreciation	(124,267)	(112,700)	(12,586)	(18,762)	(25,041)	(28,856)	(32,508)	(35,755)	(37,962)
Infrastructure Renewal Charge	-	-	(35,668)	(38,022)	(40,785)	(43,226)	(45,990)	(48,966)	(53,800)
Total Expenditure	(276,858)	(274,400)	(240,286)	(274,627)	(291,223)	(291,765)	(306,894)	(316,268)	(327,201)
Net surplus / (deficit) on operations before interest and cost of capital charges	(235,560)	(232,530)	67,105	81,526	94,183	112,611	121,973	137,860	155,663
Interest payable on Loans	(46)	(6,500)	(11,086)	(20,577)	(30,712)	(40,023)	(46,351)	(51,381)	(54,752)
Cost of Capital Charge	(198,118)	(206,160)	-	-	-	-	-	-	-
Dividend	-	-	(33,956)	(35,006)	(36,028)	(37,995)	(40,624)	(43,883)	(48,119)
Deferred Tax	-	-	(16,806)	(18,285)	(19,041)	(21,776)	(22,687)	(25,944)	(30,273)
Cash Tax	-	-	-	-	-	-	-	-	-
Net deficit on operations after cost of capital charges	(433,724)	(445,190)	5,257	7,658	8,401	12,817	12,312	16,652	22,519
Opex Margin			22.18%	23.20%	24.66%	28.09%	28.68%	30.61%	32.49%
Opex Margin excluding exceptionals			25.93%	27.29%	26.73%	28.59%	29.17%	31.09%	32.97%
Net debt / RCV gearing ratio			32.85%	43.15%	49.10%	51.82%	53.19%	53.18%	51.82%
Government Subsidy									
Phasing Subsidy	-	-	171,840	100,783	-	-	-	-	-
Pegging Subsidy	-	-	-	11,492	27,855	-	-	-	-
Low Income Subsidy [1]	-	-	9,817	21,698	34,267	44,952	48,517	50,963	54,204
Septic Tank Subsidy [2]	-	-	1,110	569	-	-	-	-	-
Total Government Subsidy	-	-	182,767	134,542	62,122	44,952	48,517	50,963	54,204

Note

1. Low Income Subsidy post 2011/12 has been assumed to remain at the same level as 2010/11 & 2011/12 (in % terms)
2. Income from septic tank emptying has been phased in line with other new charges

Balance Sheet

	2005/06 £'000 AUDITED ACCOUNTS	2006/07 £'000 CURRENT FORECAST	2007/08 £'000 WS BUSINESS PLAN MODEL	2008/09 £'000 WS BUSINESS PLAN MODEL	2009/10 £'000 WS BUSINESS PLAN MODEL	2010/11 £'000 WS BUSINESS PLAN MODEL	2011/12 £'000 WS BUSINESS PLAN MODEL	2012/13 £'000 WS BUSINESS PLAN MODEL	2013/14 £'000 WS BUSINESS PLAN MODEL
Fixed Assets									
Tangible Assets	6,046,100	855,162	1,102,036	1,405,995	1,588,491	1,742,217	1,879,351	1,993,458	2,088,473
Investments	62	62	63	65	66	68	70	71	73
	6,046,162	855,224	1,102,099	1,406,059	1,588,557	1,742,285	1,879,421	1,993,530	2,088,546
Current Assets									
Stocks & work in progress	1,685	2,000	2,880	3,268	3,381	3,295	3,426	3,473	3,532
Debtors due within one year	32,093	33,574	42,653	67,853	91,350	102,673	112,124	119,211	127,217
Cash in bank and hand	23	26	-	-	-	-	-	-	-
Interest asset (PPP - Omega & Kinnegar)	-	1,307	2,755	5,468	8,255	11,118	14,058	17,078	20,179
	33,801	36,907	48,288	76,589	102,987	117,086	129,608	139,762	150,928
Creditors: amounts falling due within one year	(88,113)	(56,200)	(427,331)	(731,682)	(905,608)	(1,035,691)	(1,150,248)	(1,234,119)	(1,287,119)
Net Current (Liabilities) Assets	(54,312)	(19,293)	(379,043)	(655,093)	(802,622)	(918,605)	(1,020,640)	(1,094,357)	(1,136,191)
Total Assets less Current Liabilities	5,991,850	835,931	723,056	750,966	785,935	823,680	858,781	899,173	952,354
Creditors: amounts falling due after one year	(4,781)	(4,000)	-	-	-	-	-	-	-
Provision for Liabilities and Charges	(4,251)	(10,831)	(46,699)	(66,952)	(93,520)	(118,448)	(141,237)	(164,977)	(195,640)
Net Assets	5,982,818	821,100	676,357	684,015	692,416	705,233	717,544	734,196	756,715
Taxpayers Equity									
General Fund	3,784,317	783,017	-	-	-	-	-	-	-
Shareholders Capital	-	-	671,100	671,100	671,100	671,100	671,100	671,100	671,100
Revaluation Reserve	2,089,227	23,283	-	-	-	-	-	-	-
Government Grant Reserve	109,274	14,800	-	-	-	-	-	-	-
Retained Profit	-	-	5,257	12,915	21,316	34,132	46,444	63,096	85,615
	5,982,818	821,100	676,357	684,015	692,416	705,232	717,544	734,196	756,715
Note - Creditors									
Creditors			(48,851)	(47,423)	(46,975)	(44,047)	(43,863)	(42,614)	(41,896)
DRD revolving loan			(333,411)	(524,710)	(696,243)	(826,330)	(937,163)	(1,017,730)	(1,065,785)
PPP-PFI/Finance leases			-	(111,190)	(111,080)	(110,780)	(110,401)	(110,059)	(109,877)
Dividend Creditor			(33,956)	(35,006)	(36,028)	(37,995)	(40,624)	(43,883)	(48,119)
Deferred Income			(11,112)	(13,353)	(15,283)	(16,540)	(18,197)	(19,832)	(21,443)
			(427,331)	(731,682)	(905,608)	(1,035,691)	(1,150,248)	(1,234,119)	(1,287,119)

Cash Flow Statement

	2005/06 £'000 AUDITED ACCOUNTS	2006/07 £'000 CURRENT FORECAST	2007/08 £'000 WS BUSINESS PLAN MODEL	2008/09 £'000 WS BUSINESS PLAN MODEL	2009/10 £'000 WS BUSINESS PLAN MODEL	2010/11 £'000 WS BUSINESS PLAN MODEL	2011/12 £'000 WS BUSINESS PLAN MODEL	2012/13 £'000 WS BUSINESS PLAN MODEL	2013/14 £'000 WS BUSINESS PLAN MODEL
Operating Cash Flow									
EBITDA (excl. IRC)			115,360	138,310	160,009	184,693	200,471	222,582	247,425
Changes in working capital			(19,282)	(27,016)	(24,059)	(14,165)	(9,765)	(8,383)	(8,783)
Change in provisions for liab. & charges			(2,563)	(7,776)	(280)	(96)	(96)	(10)	(10)
Change in provisions for bad debt			3,981	7,687	10,262	7,525	4,545	2,025	2,247
Change in deferred income balance			1,905	2,241	1,930	1,257	1,657	1,634	1,611
Change in pension & VER provisions			656	2,056	(2,456)	(4,278)	(4,347)	(4,218)	(1,848)
Total			100,056	115,503	145,407	174,937	192,465	213,630	240,642
Cash tax paid			-	-	-	-	-	-	-
Financing Cash Flow									
Change in PPP-PFI/finance leases			-	(461)	(110)	(300)	(378)	(342)	(182)
Change in PPP interest asset (Omega & Kinnegar - Off balance sheet)			(1,449)	(2,715)	(2,789)	(2,864)	(2,942)	(3,021)	(3,103)
Interest paid			(11,086)	(20,577)	(30,712)	(40,023)	(46,351)	(51,381)	(54,752)
Proceeds from asset sales			2,101	6,461	4,415	-	-	-	-
Total			(10,434)	(17,292)	(29,196)	(43,187)	(49,671)	(54,745)	(58,037)
Investing Cash Flow									
Capex - Infrastructure (incl. IRC)			(124,957)	(102,638)	(109,695)	(119,405)	(102,888)	(116,759)	(136,420)
Capex - Non-Infrastructure			(148,076)	(152,915)	(143,043)	(106,403)	(112,744)	(82,069)	(50,357)
Total			(273,034)	(255,553)	(252,738)	(225,809)	(215,632)	(198,829)	(186,777)
Total cash flow before dividends			(183,411)	(157,342)	(136,528)	(94,059)	(72,838)	(39,944)	(4,171)
Dividends paid			-	(33,956)	(35,006)	(36,028)	(37,995)	(40,624)	(43,883)
Change in net cash/debt			(183,411)	(191,298)	(171,534)	(130,087)	(110,833)	(80,567)	(48,055)
Output			333,411	524,710	696,244	826,330	937,163	1,017,731	1,065,785
Investing CF			(273,034)	(255,553)	(252,738)	(225,809)	(215,632)	(198,829)	(186,777)
Total CF			(183,411)	(191,298)	(171,534)	(130,087)	(110,833)	(80,567)	(48,055)
Net debt			(333,411)	(524,710)	(696,244)	(826,330)	(937,163)	(1,017,731)	(1,065,785)

Annex 2: Glossary of Terms

Capital expenditure (Capex) – appointed water companies' spending on capital assets (construction, purchase of machinery, etc).

Cost of capital: The minimum return that providers of capital require to prompt them to invest in or lend to the appointed water companies given their risks. (See also 'weighted average cost of capital'.)

Current cost depreciation (CCD): The depreciation charge on tangible fixed (above ground) assets based on the current values of those assets, less amortisation of deferred credits relating to grants and third party contributions. This depreciation is generally only applied to above ground assets as an infrastructure renewal charge is applied to below ground assets.

Debt: A liability, usually resulting from short-term or long-term borrowing of funds.

Equity: The risk-sharing part of an appointed water company's capital. It is usually referred to as ordinary share capital.

Infrastructure Renewal Charge: The annual accounting provision for expenditure on the renewal of infrastructure assets charged to the profit and loss account. It should reflect the company's assessment of its medium to long-term infrastructure renewals expenditure needs.

Ofwat: The Water Services Regulation Authority (Ofwat) is the economic regulator of the water and sewerage industry in England and Wales.

Operating costs: Total operating expenditure of the business net of any operating income, primarily any profits or losses on the disposal of fixed assets. Operating expenditure comprises, for example, power, rates, payroll

costs, and materials and consumables, but excludes capital-related costs such as depreciation.

Operating expenditure (Opex) – appointed water companies' day-to-day spending on running the services (staff costs, power, etc).

Northern Ireland Asset Management Plan (NIAMP) - The company's detailed description of its investment plans. NIAMP3 will report in 2008/09.

Price review (PR): The process of re-setting the company's price limit. Price limits are to be set every five years by the regulatory authority NIAUR.

Public Private Partnership (PPP): This is where a public body and a private company are brought together, for mutual benefit, in a long-term joint venture for the delivery of public services. Benefits of such an arrangement include a transfer of risk, private sector management expertise and value for money.

Regulatory capital value (RCV): The capital base used in setting price limits and the value of the regulated business which earns a return on investment.

Weighted average cost of capital (WACC): For an appointed water company, the average of its cost of debt and cost of equity capital, weighted according to the balance of debt and equity which finances the company's assets. (See also 'cost of capital'.)